

COMMONWEALTH OF KENTUCKY  
FRANKLIN CIRCUIT COURT  
DIVISION I  
CIVIL ACTION NO. 05-CI-00459

COMMONWEALTH OF KENTUCKY,  
OFFICE OF THE ATTORNEY GENERAL  
*Ex rel.* Gregory D. Stumbo in his official  
capacity as Attorney General of the  
Commonwealth of Kentucky

PLAINTIFF


v.

BOARD OF DIRECTORS FOR THE  
COMMONWEALTH POSTSECONDARY  
EDUCATION PREPAID TUITION TRUST  
FUND, et al.

DEFENDANTS

**THE FINANCE AND ADMINISTRATION  
CABINET'S MEMORANDUM IN SUPPORT  
OF MOTION FOR SUMMARY JUDGMENT**

Attorney General Greg Stumbo's Amended Complaint challenges the constitutionality of the recent Budget Bill provisions (1) prohibiting the KAPT Board from dipping into the abandoned property fund to support the KAPT Fund, and (2) requiring the KAPT Fund to return the \$13.7 Million in General Funds it received in December, 2004. The Attorney General claims that these provisions "take private property from the citizens of the Commonwealth in violation of *Ky. Const. Sections 2, 13, and 51* and impair the KAPT contracts between the citizens and the Commonwealth in violation of *Ky. Const. Section 19*." [Amended Counterclaim ¶ 2].

The Attorney General is right in one respect: the General Assembly cannot  prohibit the KAPT Board from accessing the abandoned property fund in the future to pay any unfunded liabilities owed to *current* KAPT Contract holders. The Finance and Administration

Cabinet ("the Cabinet") agrees that such a prohibition interferes with the KAPT Contract terms, and thereby violates Section 19 of the Constitution.

The Attorney General, however, is wrong in all other respects. First, the General Assembly has every right to prohibit KAPT from using the abandoned property fund to support any future KAPT Contracts. Second, the General Assembly had every right to require the KAPT Board return the \$13.7 Million in general funds it received, as the December, 2004 transfer from the General Fund to the KAPT Fund was improper. And finally, the Budget Bill's provisions do not constitute a taking of private property, or otherwise violate Sections 2, 13, or 51 of the Kentucky Constitution.

### **FACTS**

#### **A. KAPT Basics.**

Kentucky's Affordable Prepaid Tuition Fund ("KAPT Fund") was born on March 28, 2000, and is designed to serve two purposes: (1) to provide affordable access to colleges and universities to qualified beneficiaries, and (2) to provide students and their parents economic protection against rising tuition costs. KRS 164A.701(2).

The KAPT Fund has always been administered by a Board of Directors ("the KAPT Board"). *Id.* From the Fund's inception until June 30, 2005, the KAPT Board was a separate and distinct governing board, chaired by the State Treasurer, whose membership was determined pursuant to KRS 164A.703. The KAPT Board's membership changed on July 1, 2005, when the Kentucky Higher Education Assistance Authority Board of Directors ("KHEAA Board") took over as the KAPT Board. KRS 164.748(19).

The KAPT Board carries out the purposes of the KAPT Fund by selling prepaid tuition contracts ("KAPT Contracts"). Under KAPT Contracts, "purchasers" such as parents, grandparents, or other relatives, pay the KAPT Fund a set amount of money today. In exchange,

the KAPT Fund promises to pay the child's tuition and fees when they actually enroll in college [Amended Complaint, ¶¶ 25-26].

For example, imagine that in 2002, John and Jane Doe had an eight year-old son, Jim Doe. Aware of the ever-increasing costs of higher education, the Does wanted to "lock-in" the price of college tuition for Jim. Assume that in 2002, the KAPT Fund charged \$5,000 per year in tuition and fees for a student enrolling at the University of Kentucky in 2012. The Does would have entered into a KAPT Contract under which they paid \$20,000 to the KAPT Fund. In exchange, the KAPT Fund promised to pay for Jim's tuition and fees when he enrolls in college in 2012, even if the tuition and fees rise to \$15,000 per year.<sup>1</sup>

KAPT contracts are not sold year round. Instead, the KAPT Board only sells contracts during specific enrollment periods. KAPT has been open for enrollment four times: In the Fall of 2001, Spring of 2002, Fall of 2002, and Fall of 2004 [Ex. A, Depo. of KAPT Executive Director Jo Carole Ellis, p. 63].

The KAPT Fund is a stand-alone trust fund designed to consist entirely of payments from purchasers and the investment income thereon. KRS 164A.701. The KAPT Board simply takes the purchaser's payments, pools them, invests them, and hopes to generate a return on investment that is equal to or greater than college tuition inflation. The KAPT Contracts do not in any way pledge the full faith and credit of the Commonwealth – they only obligate the funds in the KAPT Fund. As the KAPT Fund properly explains on its website, "payment of the tuition guarantee is contingent upon the Fund consistently meeting its

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<sup>1</sup> This is an elementary example designed to show the basic mechanics of the KAPT Program. It does not mean that the program only applies to the University of Kentucky, or that payments must be made in lump sums. The KAPT Program has different plans based upon the type of  
(continued...)

investment targets.” [Ex. B, p. 4, “Program Overview” from KAPT Website, <http://www.getkapt.com/overview.html>]. The KAPT Contract makes it clear that a KAPT contract is not a guaranteed deal:

9.03 No Commonwealth Liability. The Purchaser, on behalf of himself, the Qualified Beneficiary, and their heirs and successors, understands and acknowledges that (a) only assets of the Fund are available to guarantee the contractual obligations to the Purchaser and Qualified Beneficiary, (b) this Agreement does not obligate the general revenue or any other fund of the Commonwealth, nor does it obligate KHEAA or any public institution (c) this Agreement shall not be considered a debt or liability of the Commonwealth or KHEAA and neither the credit nor the taxing power of the Commonwealth are pledged to paying benefits hereunder, and (d) this Agreement does not constitute a pledge of the full faith and credit of the Commonwealth.

[Ex. C, Form KAPT Contract, a/k/a the “Master Agreement”].

**B. KAPT’S Unique Guarantee – A Specific Portion of the General Fund May Be Used To Meet an Unfunded Liability.**

Kentucky’s General Assembly anticipated that the KAPT Fund’s investment income might not cover its tuition liabilities, and wanted to provide some protection to purchasers against this contingency. Accordingly, it created the following backstop funding source:

Seventy-five percent (75%) of the balance of the abandoned property funds shall be available for support of the [KAPT Fund]. Transfers from the abandoned property fund to the trust fund are authorized in order to meet any unfunded liability as determined by the Board.

KRS 393.015.

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(...continued)

school (community, in-state, or private). It also allows purchasers to make payments in installments [Ex. B].

C. The “Abandoned Property Fund” and the “KAPT Reserve Fund.”

Each year a large amount of property escheats to the Commonwealth pursuant to KRS Chapter 393. This property includes abandoned savings and checking accounts, uncashed checks, travelers’ checks, stocks, bonds, and all manner of other property. When these funds escheat to the state, they are General Fund receipts [Ex. D, Affidavit of Controller Ed Ross, ¶ 4]. Liquid assets that escheat to the Commonwealth are placed directly in the General Fund, where they are commingled with other General Fund revenues and invested [*id.* at 5]. Non-liquid abandoned assets such as stocks, bonds, and personal property may be sold by the Treasurer, and the proceeds then placed in the General Fund. KRS 393.125. All property received by the General Fund pursuant to KRS Chapter 393, while General Fund receipts, also make up the Commonwealth’s “Abandoned Property Fund.” KRS 393.010(i). This fund is not a separate trust fund or special fund such as the KAPT Fund [*id.* at ¶ 9]. Instead, it is the Commonwealth’s earmarking of monies paid into and out of the General Fund pursuant to KRS Chapter 393 [*id.*].

Abandoned property can, however, be reclaimed by people who can show they are entitled to it. In fact, Treasurer Jonathan Miller is working to return this property to people with legitimate claims:

Treasurer Miller is committed to returning unclaimed property to the residents of Kentucky. To that end, the Kentucky Department of Treasury publishes announcements in the state’s two largest newspapers and provides a search tool on this website that can be used to search the Department’s database free of charge. You can also call the Kentucky Department of Treasury toll-free at 1-800-465-4722 to determine if you or a loved one is among the thousands of Kentuckians who are owed unclaimed property.

[See Ex. E, Treasurer’s Website, [http://www.kytreasury.com/html/kyt\\_upabout.html](http://www.kytreasury.com/html/kyt_upabout.html)].

Accordingly, abandoned property goes into the Abandoned Property Fund when it is abandoned, and is paid out of the fund to those with legitimate claims to it. Kentucky’s Controller, Ed Ross, tracks the Abandoned Property Fund, which has grown every year since it

was started in 1942 [Ex. D, ¶ 11]. Attached hereto as Exhibit 1 to Mr. Ross' Affidavit is the Historical Data of the abandoned property fund. This document shows the collections, the refunds, and the net result of these transactions for each year of the Fund's existence. It shows that the fund grows every year, as only a small percentage of abandoned property is ever refunded. From the start of the program in 1942 through June 30, 2005, the state had collected \$213,002,827.83 in abandoned property, and had refunded \$38,709,842.21 – only 18 percent of its total collections [*id.* at Ex. ¶ 12]. Therefore, as of June 30, 2005, there was a net total of \$174,292,985 in the Abandoned Property Fund [*Id.*].

This Abandoned Property Fund, however, does not hold all of the abandoned property actually received pursuant to KRS Chapter 393. At Treasurer Miller's request, a separate account known as the "KAPT Reserve Fund" was created on July 1, 2003, to hold abandoned stocks and mutual funds outside of the General Fund [*Id.* at ¶ 7]. Mr. Miller's June 10, 2003 letter requesting creation of this separate account is attached hereto as Exhibit F. The creation and use of this purely administrative holding account, however, does not in any way change the nature of the funds therein. This "KAPT Reserve Fund," like the other abandoned property fund, is comprised entirely of escheated, general funds [*id.* at ¶ 8]. As of June 30, 2005, this Fund had a balance as of \$37,354,809 [*id.* at ¶ 13].<sup>2</sup>

So, in essence, there are really two abandoned property funds – the one with the \$174,292,985 balance as of June 30, 2005, and the "KAPT Reserve Fund" with the \$37,354,809 balance. These two funds constitute the overall "abandoned property fund" as defined in KRS 393.010 [*id.* at ¶ 14].

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<sup>2</sup> This fund is no longer labeled as the "KAPT Reserve Fund." For purposes of this brief, however, the Cabinet will refer to it as the "KAPT Reserve Fund" [Ex. D, ¶ 7].

**D. History Of the KAPT Fund's Performance.**

Every year the KAPT Board is required to hire an actuary to evaluate the soundness of the KAPT Fund. KRS 164A.704(7). The Board fulfilled this duty in 2002, 2003, and 2004.<sup>3</sup> The 2002 report, prepared by the actuarial firm Milliman USA, showed that the KAPT Fund had a \$2.8 Million actuarial deficit as of June 30, 2002 [Ex. G hereto; 2002 Actuarial Report and Summary Letter to Jonathan Miller]. In other words, on June 30, 2002, the present value of the KAPT Fund's current and projected obligations were \$2.8 Million higher than the present value of its assets [*id.*, Letter to Mr. Miller p. 2]. The actuary labeled this actuarial deficit as "minor and insignificant," noting that "according to our calculations, KAPT would not experience a shortfall until 2022 – almost two decades from now" [*id.*]. Moreover, the actuary noted that if a shortfall occurs in 2022, the abandoned property fund would be able to cover the gap at that time, as "the balance of the abandoned property fund today is more than nine times greater than the largest projected deficit" [*id.*].

In the 2003 actuary report, Milliman USA found that the KAPT Fund's actuarial deficit had grown to \$10.7 Million [Ex. H]. Nevertheless, in both the 2002 and 2003 reports, the actuary stated that it did not know exactly which measure of soundness to use, and that the entire concept of "actuarial soundness" is imprecise:

"Actuarial soundness" is not a precise concept and there is no generally accepted understanding of the meaning of this phrase within the actuarial profession, especially with respect to prepaid tuition plans. . . . It is not clear to us from the statute which standard of "actuarial soundness" was contemplated by the

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<sup>3</sup> KRS 146A.704(a) requires the KAPT Board to "[h]ave the actuarial soundness of the fund evaluated by a nationally recognized independent actuary on an annual basis . . . prior to each academic year." Pursuant to this statute, the KAPT Board was required to have an actuarial report performed before the start of the 2005-06 academic year. To date this year, the KAPT Board has abrogated this statutory duty, unilaterally deciding to await the outcome of this litigation before obtaining this report [Ex. A, Ellis Depo., pp. 41-44].

Legislature. For purposes of [these reports], we have adopted the “best estimate” approach.

[Ex. G, pp. 2-3; Ex. H, 3-4].

The KAPT Board hired a new actuary – Robert Crompton – to prepare the 2004 actuarial report on the KAPT Fund [Ex. I]. Mr. Crompton’s report showed that the Fund’s actuarial deficit on June 30, 2004 was \$13.7 Million – a slight increase over the \$10.7 Million actuarial deficit of 2003. This deficit, however, was still no reason for immediate concern, because under Mr. Crompton’s projections, KAPT would not experience any unfunded liability until *2019 – fifteen years after* his report was issued [Ex. J, 4/6/05 e-mail from Mr. Crompton to Assistant Attorney General Rob Jones].

Moreover, Mr. Crompton’s report also acknowledged that the potential future shortfall he projected was based entirely upon assumptions, and that the amount of the deficit *will* change based upon what actually happens in the future:

*The actuarial deficit will change from year to year* due to positive and negative cash flows and due to the change in the present value of the future contract usage and expense payments because of the passage of time. The actuarial deficit will also change due to the variance of experience from the assumptions. These variances include tuition increases, investment income, and expenses. The deficit will also change due to the growth of the program and due to the updating of the assumptions to reflect the Program’s emerging experience.

[Ex. I, p. 14 (emphasis added)].

In fact, Mr. Crompton himself projects that there is a one-in-four chance that the assets in the KAPT Fund as of June 30, 2004 will be able to completely satisfy all of the Fund’s future obligations:

The actual fund balance at June 30, 200[4] of \$89,964,665 is 86.8% of the reported actuarial liability of \$103.7 million. As indicated above, **this Fund balance is estimated to have a 25% probability of being adequate to satisfy the Plan obligations.**

[*Id.*, p. 17 (emphasis added)].



Mr. Crompton also opined that the \$13.7 Million actuarial deficit could be eliminated without tapping the General Fund through the sale of additional KAPT Contracts:

We have projected that if KAPT reopens enrollment with contract prices that include a 7.5% premium surcharge, the Program can eliminate the actuarial deficit in less than 10 years.

[*Id.* at 1].

**E. The KAPT Board Responds to the 2004 Actuarial Deficit.**

The KAPT Board responded to the \$13.7 Million actuarial deficit in two ways. First, it reopened enrollment in Fall, 2004 and leveled a 7.5 percent “premium surcharge” on all new contracts. This action had the desired effect, as the 2004 enrollments resulted in a \$1,028,962 gain to the KAPT Fund [Ex. K, 12/31/04 Actuarial Update by Mr. Crompton]. This action alone eliminated approximately 7.5 percent of the 2004 actuarial deficit – in line with Mr. Crompton’s prediction.

Second, at the December 1, 2004 meeting, the KAPT Board authorized the transfer of \$13.7 Million from the Abandoned Property Fund to the KAPT Fund. KAPT Board Chairman Jonathan Miller advocated this transfer of General Funds on grounds that it would “improve the long-term viability of the program” [Ex. L, p. 7, 12/1/2004 Minutes of KAPT Board Meeting]. Chairman Miller reported to the Board that the Attorney General confirmed that the Board had the authority to make this transfer [*id.*; see also Ex. M, p. 3, 6/23/04 Letter from the Attorney General’s Office to Treasurer Miller]. Accordingly, a total of \$13,700,051 was transferred from the General Fund to the KAPT Fund in December, 2004.<sup>4</sup>

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<sup>4</sup> The \$13.7 Million transfer at issue was technically a series of three transfers made within days of each other totaling \$13.7 Million. To effectuate these transfers, the Treasury instructed that \$13,700,051 in securities held in the KAPT Reserve Fund be sold. The cash received on the sale(s) of securities were deposited into the General Fund. Then the total of \$13,700,051 was  
(continued...)

These two actions had the desired effect – they wiped out the actuarial deficit. In fact, they even created an actuarial *surplus* in the KAPT Fund of \$2,162,047 as of December 31, 2004 [Ex. K].

**F. In 2005 the General Assembly Passes Legislation Prohibiting The KAPT Board From Dipping Into the General Fund.**

The General Assembly did not approve of the KAPT Board's transfer of general funds to eliminate a speculative, long-term actuarial deficit in the KAPT Fund. Accordingly, in the 2005 Budget Bill, the General Assembly required the KAPT Board to return the \$13.7 Million in General Fund monies the KAPT Fund received in December, 2004:

Notwithstanding KRS 164A.701 and 393.015, the Board of Directors of the Kentucky Higher Education Assistance Authority shall return the \$13,700,051 transferred to the Kentucky Affordable Prepaid Tuition Program from the KAPT Reserve Fund, by action of the KAPT Board of Directors on December 1, 2004, to the General Fund in fiscal year 2004-2005.

[HB 267, p. 126]. The Budget Bill also repealed KRS 393.015, and thereby prohibited any further use of abandoned property funds (which are general funds) for the support of KAPT contracts:

No general fund moneys or abandoned property funds shall be available for the support of the Commonwealth postsecondary education prepaid tuition trust fund.

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The following KRS section is repealed: 393.015. Use of abandoned property funds to support Commonwealth postsecondary education prepaid tuition trust fund.

[HB 267, pp. 312, 314].

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(...continued)

transferred from the General Fund to the KAPT Fund in a series of three wire transfers that occurred on December 7, 10, and 15, 2004 [Ex. D ¶ 16].

Instead of tapping the General Fund, the General Assembly amended KRS 164A.701(1) to mandate that the KAPT Board achieve actuarial soundness by charging sound premiums, levying surcharges on new contracts, and suspending the sale of contracts whenever appropriate:

If the assets of the fund are insufficient to ensure the actuarial soundness of the fund, as reported by the actuary, the board shall adjust the price of subsequent purchases of prepaid tuition contracts to the extent necessary to restore the actuarial soundness of the fund. The board may suspend the sale of prepaid tuition contracts until the next annual actuarial evaluation is completed if the board determines the action is needed to restore the actuarial soundness of the fund.

KRS 164A.707(1).

### ARGUMENT

Attorney General Stumbo's challenge to the recent Budget Bill is well-taken in one respect: the General Assembly cannot prohibit the KAPT Board from accessing the abandoned property fund *in the future* to pay any unfunded liabilities owed to *current* KAPT Contract holders. This prohibition violates Section 19 of the Constitution in that it impairs existing contracts.

The rest of Attorney General's lawsuit, however, is groundless. The Attorney General tries to manufacture a way to allow the KAPT Fund to keep the \$13.7 Million it received in December, 2004. But the initial receipt of this money was improper, as the KAPT Fund had no "unfunded liability" to cover at the time. In fact, the KAPT Fund's own 2004 Actuarial Report projected that no unfunded liability would arise until 2019. Accordingly, the \$13.7 Million should be immediately returned to the General Fund as directed and authorized by the 2005 General Assembly, where it can be used to serve the Commonwealth's immediate and pressing needs.

**I. THE GENERAL ASSEMBLY'S REPEAL OF KRS 393.015 IS UNCONSTITUTIONAL AS TO EXISTING KAPT CONTRACTS.**

Since KAPT's inception, 8,901 KAPT Contracts have been sold in Kentucky. Each Contract contains language making clear that there is absolutely no guarantee that the contract beneficiary will receive the promised tuition benefits if the investment income does not outpace tuition inflation. Nevertheless, the contracts all represented to the Purchaser that "[u]nder KRS 393.015, 75 percent of the balance of the abandoned property fund administered by the Kentucky State Treasurer would be available to meet any unfunded liability of the Fund, as may be determined by the Board" [Ex. C, § 9.02].

The Cabinet believes that the Commonwealth must live up to this promise. Therefore, the Cabinet agrees with the Attorney General that the recent repeal of KRS 393.015, and specific prohibition against use of abandoned property funds for payment of unfunded liabilities, violates Section 19 of the Kentucky Constitution as to *current* KAPT Contracts, which are those entered into prior to the 2005 Budget Bill. The Cabinet, however, disagrees with the Attorney General over *when* the KAPT Board is allowed to tap the Abandoned Property Fund.

**II. THE GENERAL ASSEMBLY'S REPEAL OF KRS 393.015 IS CONSTITUTIONAL AS TO FUTURE KAPT CONTRACTS.**

The General Assembly had every right to repeal KRS 393.015, and the backstop funding mechanism it created, as to any *future* KAPT Contracts. After all, the legislature alone has the "power of the purse," and therefore has every right to repeal a statute such as KRS 393.015:

It is clear that the power of the dollar -- the raising and expenditure of the money necessary to operate state government -- is one which is within the authority of the legislative branch of government. The Constitution of the Commonwealth so states and we have so stated.

*Com. ex rel. Armstrong v. Collins*, 709 S.W.2d 437, 441 (Ky. 1986). There is nothing sacred about KRS 393.015 that shields it from repeal as to future contracts, as future purchasers will be on notice that the Abandoned Property Fund does not back their KAPT Contract.

It is hard to tell from the Attorney General's Amended Complaint if he is challenging the repeal of 393.015 as to *future* contracts. He may not be, as he states that he is seeking to uphold the "Commonwealth's obligations under KAPT contracts entered into prior to the enactment of HB 267" [Amended Complaint, p. 5]. It is clear, however, that the KAPT Board, which filed a cross-claim mimicking the Attorney General's claims, does not challenge the repeal of KRS 393.015 as to future contracts, but only as to current contracts:

The repeal of KRS 393.015 is unconstitutional, and void, to the extent it bars KAPT's access to the Unclaimed Property Fund to satisfy actuarial deficits *related to contracts entered into prior to such repeal*.

[KAPT Cross-Claim, p. 6 (emphasis added)].<sup>5</sup> KAPT's Executive Director, Jo Carole Ellis, confirmed this is KAPT Board's position:

Q: Is the KAPT Board challenging the repeal of KRS 393.015 and the guarantees therein as to any future enrollees? In other words, is the KAPT board challenging the repealing of the statute which would say to future enrollees: There is no guarantee by the unclaimed property funds?

Ms. Ellis: My understanding is it only involves those already in the program.

[Ex. A, Ellis Depo., p. 50].

Therefore, it appears that all parties likely agree that (1) the abandoned property fund should be available to cover any unfunded liabilities that may arise on the 8,901 KAPT contracts that have already been sold, and that (2) the General Assembly's repeal of KRS 393.015 as to future KAPT Contracts is constitutional. What the parties do not agree on is when

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<sup>5</sup> The KAPT Board dismissed its cross-claim, wisely recognizing that it was duplicative of the Attorney General's Amended Complaint and therefore unnecessary.

the Abandoned Property Fund can be accessed by the KAPT Board. The Cabinet maintains the December, 2004 transfer was premature and therefore improper.

**III. THE GENERAL ASSEMBLY CORRECTLY DEMANDED THE RETURN OF THE \$13.7 MILLION BECAUSE THE INITIAL TRANSFER WAS IMPROPER.**

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KRS 393.015 states as follows: "Transfers from the abandoned property fund are authorized to meet any *unfunded liability* determined by the [KAPT] board" (emphasis added). The term "unfunded liability," however, is not defined anywhere in the Kentucky statutes, nor is it defined anywhere in Kentucky case law. Accordingly, this Court must determine what the General Assembly intended when it used this particular phrase in KRS 393.015.

The Attorney General interprets the term "unfunded liability" as synonymous with "actuarial deficit," and therefore maintains that the \$13,700,051 transfer by the KAPT Fund to cover the 2004 actuarial deficit was appropriate under this statute. The Cabinet respectfully disagrees, as the overwhelming evidence shows that the General Assembly intended "unfunded liability" to mean a *currently* unfunded liability -- not a *projected* funding shortfall. In other words, an unfunded liability arises under KRS 393.015 when, and only when, the KAPT Fund cannot make tuition payments when they are actually due. So, if the 2004 Actuarial Report is right, an "unfunded liability" will not arise until 2019.

The Cabinet's interpretation of "unfunded liability" is supported at every turn. First, the mere fact that the General Assembly explicitly demanded that the \$13.7 Million be returned to the General Fund proves as a matter of law that the December, 2004 transfer was not in line with the General Assembly's intent for KRS 393.015. If the General Assembly equated "unfunded liability" with "actuarial deficit," as the Attorney General claims, then the General Assembly naturally would not have had such an adverse reaction to the KAPT Board's action.

In fact, this transfer ruffled the General Assembly's feathers so much that it went a step too far, and entirely cut off the KAPT Board's ability to access the Abandoned Property Fund. As set forth above, however, the Cabinet agrees that this repeal is unconstitutional as to current KAPT Contracts. Nevertheless, the General Assembly's unmistakable disapproval of the KAPT Board's actions is proof positive that it did not, and does not, intend "unfunded liability" to be synonymous with "actuarial deficit."

Second, the legislature articulated exactly what money it intended to be in the KAPT Fund:

The fund shall consist of payments received from prepaid tuition contracts under KRS 164A.700 to 164A.709. Income earned from the investment of the fund shall remain in the fund and be credited to it.

KRS 164A.701. This statute does not contemplate the KAPT Fund receiving, or in any way "consisting" of, General Fund monies. Again, the legislature's intent was that a portion of the General Fund would be available to pay beneficiaries' tuition if, and only if, the funds described in KRS 164A.701 run out.

Third, equating "unfunded liability" with "actuarial deficit" is an extremely dangerous proposition in regards to the KAPT Fund, as it allows the KAPT Fund to hold already sparse general funds captive for decades, even when it is entirely possible that KAPT Fund will never need the money. After all, the 2004 Actuarial Report states in no uncertain terms that there is a substantial chance that the \$13.7 Million transferred to the KAPT Fund will never be needed. If this turns out to be true, and the \$13.7 Million is allowed to stay in the KAPT Fund, these General Fund revenues will have been held captive for years and will have served absolutely no purpose except to provide a pool of money for a possible unfunded liability many years down the road that may never occur. These millions of dollars would have been unavailable to take care of this state's immediate and pressing budgetary needs.

What is worse, what happens if an actuarial surplus arises after the KAPT Fund receives general funds, as happened in December, 2004? At that time the KAPT Fund realized a \$2,162,047 actuarial surplus as a result of the \$13.7 Million transfer, because the KAPT Fund had realized five months of favorable investment returns, as well as income from new enrollments, in the five-month period between the June 30, 2004 date of the actuarial deficit and the December 1, 2004 vote to transfer the \$13.7 Million. Is the KAPT Fund required to return this surplus amount to the General Fund to level its assets and projected liabilities? The Attorney General thinks not, arguing that the entire \$13.7 Million in General Funds transferred to the KAPT Fund must stay there forever, even if the actuarial deficit is erased in future years by, e.g., an economic upturn that causes the KAPT Fund investment income to increase dramatically.

This position is nonsensical. When the General Assembly allowed the KAPT Board to use General Fund monies to “meet any unfunded liability,” it certainly did not intend to allow the KAPT Board to take general funds to cover an actuarial deficit, and then keep those funds forever, simply because the actuary’s prediction was wrong and the money was never needed. The Attorney General’s interpretation of “unfunded liability,” however, permits exactly that – windfalls to the KAPT Fund because of inaccurate actuarial predictions. These windfalls, of course, are received at the expense of the General Fund, and therefore at the expense of all Kentuckians. The only way to ensure that these windfalls are not obtained is to interpret “unfunded liability” as arising when the KAPT Fund cannot actually pay its bills.

Furthermore, under the Attorney General’s view, what exactly qualifies as an “unfunded liability” and what does not? Obviously the Attorney General believes a 75 percent chance of a shortfall arising in 2019 qualifies as an “unfunded liability.” But what if in two years the economy has improved, and the actuary predicts a 50 percent that the KAPT Fund will



be able to meet all of its needs, but a 50 percent chance that there will be a shortfall in 2019? Is this 50 percent chance of a shortfall an “unfunded liability?” And what if the actuary predicts that there is only a 25 percent chance of a shortfall in 2019? Under the Attorney General’s position, any possibility of a future deficit is an “unfunded liability,” and thus the General Fund can be tapped at anytime to “improve the long-term viability of the program.”<sup>6</sup>

This slippery position ignores the entire purpose of KRS 393.015 – to provide a backstop source of funding to the KAPT Fund when, and only when, it is actually needed. The statute does not provide the KAPT Board with an ATM card that it can use to withdraw millions of dollars of General Fund monies needed today upon the mere prediction of a shortfall in 2019.

Accordingly, the December, 2004 transfer of \$13.7 Million from the General Fund to the KAPT Fund was improper. The \$13.7 Million transferred to the KAPT Fund in December, 2004 should be immediately returned to the General Fund.

**A. The Abandoned Property Fund’s Future Is Extremely Secure.**

There is very little (if any) reason for KAPT Contract holders to worry about the strength or future availability of the abandoned property fund. Despite Treasurer Miller’s (and previous officials’) efforts to return abandoned property to the citizens of Kentucky, the Abandoned Property Fund has done nothing but grow since its inception. And it continues to grow at staggering rates. At the end of fiscal year 2005, there was \$211,674,794 in the fund – an amount that exceeds the *entire liability* of the KAPT Fund by roughly \$100 Million. [Ex. D, ¶ 14]. And since 2000, the year the KAPT program was started, the Abandoned Property Fund has

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<sup>6</sup> KAPT’s own actuary stated in no uncertain terms that “‘actuarial soundness’ is not a precise concept and there is no generally accepted understanding of the meaning of this phrase in the actuarial profession, especially which respect to prepaid tuition plans” [Ex. G, pp. 2-3, Ex. H, pp. 3-4].

grown by \$106,350,910 – over 61 percent. The 2004 actuarial report, which was produced before the \$13.7 Million transfer, properly concluded that “KAPT is actuarially sound based on the combined [KAPT Reserve Fund] and [KAPT] Fund amounts” [Ex. I].

Therefore, it is all but certain that there will be enough money in the abandoned property fund to cover any unfunded liability the Fund may encounter in the future. Most investors only dream of having something as large and solid as the Abandoned Property Fund backing up their investment. While there is an extremely remote chance that all abandoned property will be reclaimed by 2019, this was a minimal risk the KAPT Contract holders voluntarily assumed in return for the incredible benefits of a KAPT Contract.

Moreover, when KAPT Purchasers bought their contracts they either knew, or should have known, about the risk of relying on the abandoned property fund, as the Commonwealth has been returning abandoned property to its rightful owners ever since the fund’s inception in 1942 – well before they signed their contract. But these investors also knew, or should have known, that the chances of the Abandoned Property Fund being exhausted, whether in 2019 or later, are infinitesimal.

Suffice it to say, KAPT Contract holders were very astute investors when they purchased KAPT Contracts, as the overwhelming odds are the abandoned property fund will continue to grow, and thereby will completely secure their contracts. This backing, however, may only be tapped if and when there is an actual deficit – it may not be tapped, and thereby tie up general funds, to merely guard against the possibility of a deficit fifteen years down the road.

**B. The \$13.7 Million Deposited Into the KAPT Fund are Public Funds That Can Be Differentiated From Other KAPT Funds and Returned to the General Fund.**

In a last-ditch effort to prevent the General Assembly from reclaiming the \$13.7 Million in general funds improperly transferred to the KAPT Fund in December, 2004, the

Attorney General claims that this public money was hopelessly commingled with private funds, and therefore cannot be returned to the General Fund. The Attorney General even produced numerous affidavits, statements, and account records to try to support this claim. This argument, however, fails instantly as a matter of law for many undeniable reasons.

First, all funds deposited into the KAPT Fund are public funds. Each Purchaser explicitly agreed to this in the KAPT Contract:

**8.02 Public Funds. Assets of the Fund shall constitute public funds of the Commonwealth** and may be invested in any instrument, obligation, security, or property which constitutes legal investments for the investment of public funds in the Commonwealth which are deemed most appropriate by the Board.

[Ex. C, ¶ 8.02 (emphasis added)]. The Attorney General now argues that this crystal-clear provision of the KAPT Contract does not really mean what it says. The Cabinet respectfully disagrees. Just as the General Assembly cannot renege on the explicit contractual language obligating the Abandoned Property Fund to guarantee current contracts, the Purchasers cannot renege on the contractual language stating that assets of the KAPT Fund are public in nature. Therefore, public money was never commingled with private money in the KAPT Fund – it was all public to begin with.

Nevertheless, even if the Purchaser's contributions to the KAPT Fund (and the income earned thereon) are considered private funds, the fact that \$13.7 Million in public money is commingled with these allegedly private funds does not turn the \$13.7 Million into private money.

To the contrary, it is black-letter Kentucky law that the mere commingling of funds does not change the character of those funds. If public funds can be differentiated from the private funds, they can be transferred out of a special fund or trust fund back into the General Fund. *See Com. ex rel. Armstrong v. Collins*, 709 S.W.2d 437, 441 (Ky. 1986). And the source

of the funds is the key to their characterization. If the Court can determine the source of the monies in a fund, they can be distinguished as “private” or “public.”

For instance, in *Ross v. Gross*, 300 Ky. 337, 188 S.W.2d 475 (1945), certain county officials paid fees that they collected into the State Treasury. A certain percentage of those fees were allocated to pay the officials’ salaries and expenses. The General Assembly tried to claim this money, asserting that once the funds were deposited into the State Treasury they became public money and were then under the control of the General Assembly. Kentucky’s highest court disagreed, stating that such commingling in the State Treasury did not turn the funds into “public money:”

[S]ince the money belonged to the appellees or the County, its payment into the State Treasury did not vest the State with title thereto or a right to its custody.

*Id.* at 477.

Similarly, in *Thompson v. Kentucky Reinsurance Ass’n*, 710 S.W.2d 854 (Ky. 1986), the Commonwealth claimed that when private workers’ compensation assessment money was deposited into the state treasury, and thereby commingled with public money, it lost its character as private money and was therefore available for transfer to the General Fund. The Court rejected this argument, holding that the assessments remained private, even when commingled with public funds. *Thompson*, 710 S.W.2d at 858. The Cabinet respectfully submits that the street runs both ways – just as a deposit into the State Treasury does not turn private funds into public funds, the deposit of public funds into the allegedly private KAPT Fund does not turn them into private funds, or mean that they cannot be differentiated.

The fact that funds can be differentiated by source is confirmed by the very existence of the Abandoned Property Fund. After all, property received by the Commonwealth pursuant to KRS Chapter 393 are undeniably General Fund receipts that are, for the most part,

deposited and invested with all of the other money in the General Fund. This money and property, however, is differentiated from the other general funds by source – it is money received (and expended) pursuant to KRS Chapter 393. The very existence of this fund proves that the Attorney General is wrong when he claims that money cannot be differentiated once it is commingled and invested.

Moreover, whenever a KAPT Participant cancels a KAPT Contract, his initial contribution is refunded to him [Ex. C, ¶ 6.04]. Accordingly, the KAPT Fund obviously tracks its income by source, as it can differentiate each Participant's contribution from the others. Therefore, the General Fund's \$13.7 Million contribution to the KAPT Fund can be differentiated from the other contributions. The Attorney General's claim to the contrary defies logic.

In fact, the General Assembly was generous in only requiring \$13.7 Million be refunded, as the ~~investment income~~ earned on this wrongfully obtained amount is also public in nature. The General Assembly had every right to demand this interest income be returned, but it chose not to. Accordingly, there is no need to even determine whether the investment income can be differentiated. The principal amount unquestionably can be, and should be refunded immediately.

It appears, however, that the Attorney General may also argue that this money cannot be refunded because KAPT invested it, and therefore it is no longer liquid. This argument is a non-starter. An entity is not entitled to keep money it improperly receives simply because it invested it. If this were the case, any defendant could shield and keep any wrongfully obtained money by simply buying stock or bonds. The bottom line is the KAPT Fund improperly obtained \$13.7 Million from the General Fund, and now must return it. If that means

it must sell some investments to do so, then so be it. In fact, any argument by the Attorney General to the contrary is rather ironic, as the Cabinet actually liquidated stock in the KAPT Reserve Fund in order to fulfill the KAPT Board's demand for \$13.7 Million. The KAPT Board now must do the same.

The fallacy of the Attorney General's position is further revealed by the following example. Imagine that the KAPT managers mistakenly overcharged a KAPT purchaser \$5,000 for a KAPT Contract, and then invested this money with other KAPT Funds. Later, the purchaser discovers the error and demands repayment of the \$5,000. Under the Attorney General's view, this money cannot be refunded, because when it was deposited into the KAPT Fund and invested, it instantaneously became the property of all KAPT Participants. To refund this money would be a taking of other participants' money under the Attorney General's incorrect view.

## **II. THE BUDGET BILL PROVISIONS IN QUESTION DO NOT VIOLATE SECTIONS 2, 13, OR 51 OF THE CONSTITUTION.**

### **A. The Return of \$13.7 Million to the General Fund Is Not A Taking Of Private Property.**

Because the Attorney General claims that funds deposited into the KAPT Fund instantly become private funds, he claims that the refund of \$13.7 Million required by the Budget Bill is a taking of private property, and therefore violates Section 13 of the Kentucky Constitution. This is nonsense.

As explained above, the \$13.7 Million in question is not private property. First, the KAPT Purchasers agreed in the KAPT Contracts that all funds in the KAPT Fund are public. Second, even if money received from KAPT Purchasers (and the income earned thereon) is considered "private," that just means that the money lies beyond the General Assembly's reach. The KAPT Fund, however, actually owns the money in the fund – not the participants. What the

participants own is a contractual right to tuition payments when the designated beneficiary attends college. The purchaser gave up ownership of his or her money in exchange for this contractually defined benefit. This is proven by the fact that the participants have no control over the investment of their contributions. The KAPT Fund owns the money, and therefore it cannot be "taken" by the Commonwealth.

Nevertheless, even if participants and/or beneficiaries are deemed to own their contributions to the KAPT Fund and any investment income earned thereon, none of these funds are being reclaimed by the legislature. Instead, the Budget Bill only reclaims public funds that were improperly transferred to the KAPT Fund. It generously leaves the investment income earned on those funds when they were in the KAPT Fund. Any argument that the wrongful deposit of \$13.7 Million into the KAPT Fund bestowed KAPT participants and/or beneficiaries ownership of that money is absurd. Accordingly, the Attorney General's commingling and taking arguments are meritless, and should be summarily rejected.

**B. The Budget Bill Provisions at Issue Do Not Violate Section 51.**

The Attorney General claims that the Budget Bill provisions in question violate Section 51 of the Kentucky Constitution. This too is nonsense.

Section 51 of the Kentucky Constitution requires three things: (1) that statutes relate to only one subject, (2) that the subject be expressed in the title, and (3) any revision or amendment of statutes should be reenacted and republished at length:

No law enacted by the General Assembly shall relate to more than one subject, and that shall be expressed in the title, and no law shall be revised, amended, or the provisions thereof extended or conferred by reference to its title only, but so much thereof as is revised, amended, extended or conferred, shall be reenacted and published at length.

Ky. Const. § 51. It is well-established, however, that the Kentucky legislature is vested with the power to amend or repeal statutes in a budget bill, so long as the action is related to

“appropriations providing financing for the operations, maintenance, support, and functioning of any governmental agency.” *Grayson Co. Bd. of Ed. v. Casey*, 157 S.W.2d 201, 209 (Ky. 2005); *see also Commonwealth, Education & Humanities Cabinet v. Gobert*, 979 S.W.2d 922 (Ky. App. 1998); *Kentucky River Authority v. City of Danville*, 932 S.W.2d 374, 376 (Ky. App. 1996).

And that is exactly what happened here: The legislature amended KRS 164A.707, a statute specifically concerning the financial maintenance and support of the KAPT Fund, by republishing the entire statute in the Budget Bill [HB 267, p. 312-314]. The legislature then repealed KRS 393.015, which also concerned the financial maintenance and support of the KAPT Fund, in the Budget Bill:

The following KRS section is repealed: 393.015 Use of abandoned property fund to support Commonwealth postsecondary education prepaid tuition fund.

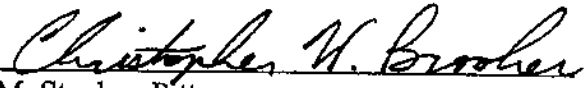
[HB 267, p. 314]. Therefore, the budget bill provisions in question comply with Section 51 of the Kentucky Constitution. The Attorney General’s claim to the contrary should be dismissed.

### CONCLUSION

The Attorney General was justified in bringing part of this lawsuit, as the Budget Bill provisions prohibiting any use of the Abandoned Property Fund to support KAPT Contracts was an unconstitutional impairment of the current KAPT Contracts. The Attorney General went too far, however, in demanding that the \$13.7 Million in general funds transferred to the KAPT Fund in December, 2004 be allowed to stay in the KAPT Fund. It is clear from the General Assembly’s actions, as well as the statutes and other evidence, that KRS 393.015 only opens the Abandoned Property Fund to meet current, unfunded liabilities – not to erase speculative actuarial deficits that may never occur. The \$13.7 Million should be immediately returned to the General Fund.



Respectfully submitted,

A handwritten signature in cursive script, reading "Christopher W. Brooker". The signature is written in dark ink and is positioned above the printed name and address.

M. Stephen Pitt

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